

North Carolina: Groups express concern about proposed market-based sourcing rules



David M. Kall | Thursday, January 12, 2017

Last fall, the North Carolina Department of Revenue (Department) published [proposed administrative rules](#) pertaining to the application of market-based sourcing of receipts for purposes of the sales factor. The rules only apply to receipts from sales of other than tangible personal property, in the context of licenses and sales of intangible property where the substance of the transaction resembles a sale of goods or service. The new rules apportion income based on the location of the delivery of the relevant services, as distinct from the location of the taxpayer's employees or property.

The scope of the rules extends to the following:

1. Determining to what extent the market for a sale is in North Carolina;
2. Approximating the state or states of assignment where this cannot be determined;
3. Excluding receipts from the sale of intangible property from the numerator and denominator of the sales factor; and
4. Excluding receipts from the denominator of the sales factor where the state or states of assignment cannot be determined.

The rules provide guidance on these issues, among others:

1. The Secretary of State's authority to adjust a taxpayer's return;
2. The receipts from a sale of a service are situated to North Carolina to the extent that the service is delivered to a location in North Carolina;
3. The assignment of receipts from a sale of in-person services to North Carolina, to the extent that the customer receives the service in North Carolina. The rules provide additional instruction for determining the location where a service is received;
4. The assignment of receipts to one or more states when the sale of a service is delivered physically or electronically to the customer, depending upon the method of delivery of the service and the nature of the customer.

The rules also address the license or lease of intangible property, the sale of intangible property, and special circumstances involving software transactions, digital goods and services, and telecommunications companies.

Concerns

In response to the proposed rules, several stakeholders sent letters to the Department to express their concerns, the deadline for which was January 3, 2017. For example, one item that the [Council on State Taxation](#) (COST) pointed out was a discrepancy between the language contained in the model regulation currently

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pending and the proposed statutory language, which is consistent with the Multistate Tax Commission's model market-based sourcing statute.

COST was also troubled by what it considers to be a one-sided approach for determining when a tax agency can retroactively challenge a taxpayer's assignment of receipts or reasonable approximation methodology. COST's letter goes on to identify several other issues that it feels will make compliance more difficult.

The crux of the [Motion Picture Association of America's](#) (MPAA) interest was that the rules, as applied to broadcasters, made North Carolina an "outlier" among the states; the methodology relied upon for sourcing broadcaster receipts is one that is outdated, such that only 15 states still utilize it. This "viewing audience" method, in MPAA's view, "has become an unworkable and unreliable anachronism," counter to the "clear trend across the country."

Similarly, the [National Taxpayers Union](#) (NTU) also has "deep reservations about the proposal's shift to an audience-based corporate tax apportionment system," opining that its "archaic approach" is "outdated and unworkable." NTU explains that the audience based apportionment method is defective because it "conflates the advertiser's market with that of the content providers;" content providers do not deliver the content, nor do they have a direct relationship with the viewing audience, which renders them incapable of determining consumers' tax liability.

The [North Carolina Retail Merchants Association](#) (NCRMA) set forth different considerations: uncertainty and subjectivity with regard to the Secretary of State's authority to adjust a taxpayer's return. NCRMA argued that this "unfettered and unchecked authority" would give the Secretary "unilateral ability" to make unfavorable adjustments. Because "Secretaries of Revenue change over time, so does the interpretation" of what constitutes a reasonable adjustment. In addition, the rules would allow a Secretary "to effectively change the market base sourcing rules without proceeding through formal rule-making" process, which undermines the certainty that businesses rely on.

Further, the NCRMA, referring to the fact that the rules do not require a fiscal note, suggested that allowing a rules change without one "does not provide the necessary transparency to what the policy implications are of such a change." This ultimately sends a negative signal that what is here today may be gone tomorrow.

Finally, and more simply, the [North Carolina Bankers Association](#) (NCBA) sought clarification of the services that banks provide, because these services "could fall under multiple categories of professional services."



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